IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF AMICUS CURIAE OF THE NATIONAL ASSOCIATION OF MANUFACTURERS OF THE UNITED STATES OF AMERICA

INTEREST OF THE AMICUS CURIAE[1]

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[1] This brief is filed with the written consent of the parties pursuant to Supreme Court Rule 42(2). Letters of consent are on file with the Clerk of this Court.

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The National Association of Manufacturers of the United States of America ("NAM"), a New York corporation not for profit, is an organization exempt from Federal income taxation under Section 501(c)(6) of the Internal Revenue

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Code of 1954 ("the Code") as a business league. It is a trade association which represents the common business interests of more than 12,000 manufacturing corporations.

A very substantial number of the members of the NAM value their inventories under the valuation method known as "cost or market, whichever is lower," which method is specifically authorized under Treasury Regulations § 1.471-4, and have for many years written down the value of their inventories to reflect the presence of "excess inventories," i.e., inventories held in quantities exceeding those which can be sold, as required to comply with generally accepted accounting principles.

These write-downs of excess inventories, which are required in order to obtain an income statement certified by a certified public accountant, and thus also required by the Securities and Exchange Commission under Section 19(a) of the Securities Act of 1933, have for many years been allowed by the Internal Revenue Service in the computation of taxable income.

The issue in this case to which this brief is directed is whether the Commissioner of Internal Revenue ("the Commissioner") has the discretion under Code § 471 to disallow such write-downs and require that excess inventories be carried at cost for tax purposes until they are scrapped, based solely upon his unsupported assertion that such write-downs do not clearly reflect income.

Should the Seventh Circuit's decision[2] in this case not be reversed by this Court, members of the NAM, as well as many other taxpayers engaged in manufacturing and non-manufacturing activities, will be adversely and substantially affected.

[2] *Thor Power Tool Co.* v. *Commissioner of Internal Revenue*, 563 F. 2d 861 (7th Cir., 1977).

The imposition of extensive retroactive tax liabilities[3] upon income which will never be realized will result either in heavy financing costs or in uneconomical scrapping of inventories, either of which will cause substantial and unnecessary price increases.

SUMMARY OF ARGUMENT

The method of accounting for excess inventories by Thor Power Tool Co. ("Thor") represented the "best accounting practice" in its business, under Code § 471, and the Commissioner's action in rejecting this method, without explanation, as not clearly reflecting Thor's income, and in substituting a method clearly distortive of income, was arbitrary and unlawful.

[3] By the reversal of all prior write-downs on excess inventories existing in years open under the statute of limitations.

ARGUMENT

It is undisputed in this proceeding that Thor's method of accounting for excess inventories was in accordance with generally accepted accounting principles and represented the "best accounting practice" in its trade or business, within the meaning of Code § 471.[4] It is also clear that the intention of Congress, followed for many years by the Treasury Department under its regulations, was that an inventory method which represented the "best accounting practice" in a business would be accepted as being clearly reflective of income under Code § 471.[5]

In view of these undisputable conclusions, it is astonishing that the courts below saw fit to hold that the Commissioner of Internal Revenue was free to disregard Thor's inventory valuation by a naked assertion that it did not clearly reflect income.

The Tax Court attempted to soften this appearance of untrammeled discretion by asserting that Thor's write-downs of excess inventories were arbitrary,[6] in the face of uncontradicted expert testimony of certified public accountants and experienced management that they were not.

The Court of Appeals attempted to do the same by unearthing an "inference" in the Tax Court opinion that Thor had been inconsistent in the use of its method.[7]

Despite these attempts to soften the arbitrary nature of the action taken here by the Commissioner, the end result of the holdings below, if allowed to stand, is that, in the

[4] *Thor Power Tool Co.* v. *Commissioner*, 563 F. 2d at 867.

[5] Pet. Br. 31-35.

[6] *Thor Power Tool Co.*, 64 T.C. 154 (1975), at 170.

[7] *Thor Power Tool Co.* v. *Commissioner*, 563 F. 2d at 868.

highly significant area of inventory valuation, the power of the Commissioner to accept or reject inventory methods would be absolute and not subject to review. He need not explain why a method of inventory valuation in accordance with generally accepted accounting principles and constituting the best accounting practice fails to clearly reflect taxable income; he needs only to say that the method is unacceptable.

The absence of any expressed rationale for the Commissioner's determination is understandable. There is none. As pointed out in Petitioner's brief,[8] the valuation of excess inventories at cost until they are scrapped results in distortion, rather than in clear reflection of income. Indeed, when the Commissioner, after almost 60 years of silence (and twelve days after the decision of the Court of Appeals below), finally took a published position regarding percentage write-downs of excess inventories, he gave no reasoned explanation of his position, but merely referred to a series of irrelevant provisions in the regulations under Code § 471, and concluded the method was unacceptable. Rev. Rul. 77-364, I.R.B. 1977-41, p. 9.

If all that is required of the Commissioner to reject an inventory method which is in accordance with generally accepted accounting principles and is the best accounting practice is silence in the regulations, it is submitted that the concern of the NAM is justified.

This Court recently held, in *Central Illinois Public Service Company* v. *United States*, No. 76-1058, February 28, 1978, that the Commissioner could not retroactively impose upon employers a liability to withhold income taxes on reimbursements of luncheon expenses of employees where,

[8] Pet. Br. 55-56.

in the tax year in issue, "not one regulation or ruling required withholding on any travel expense reimbursement," and where no employer, in viewing the regulations, "could reasonably suspect that a withholding obligation existed." While the need for precise rules in the area of withholding tax liability may be greater than in the general area of income tax liability, it is submitted this this Court's concern regarding administrative inaction in that case should be equally applicable to an area of as widespread importance as inventory valuation methods.

It is interesting in this connection to compare the inaction of the Commissioner in this case with the reasoned actions taken in connection with the so-called "base stock" method of inventory valuation, whose rejection by the Commissioner was approved by this Court in *Lucas* v. *Kansas City Structural Steel Co.*, 281 U.S. 264 (1930).[9]

In 1919, a Treasury ruling, Tax Board Ruling No. 65, 1 C.B. 51, was published, explaining at length why the "base stock" method was not acceptable under the predecessor of Code § 471, as being distortive of income and not in accord with the "best accounting practice". The 1922 version of Regulations 45 next specifically prohibited the use of the method.[10] On the basis of the ruling, a discussion of the annual distortive operation of the "base stock" method, and the fact that the taxpayer "disclaims any defense of the base stock method", this Court stated that the method "does not conform with the general or best accounting methods and is apparently obsolete." Small wonder that the Court concluded that the taxpayer had not met "the heavy burden of proving that the Commissioner's action was plainly arbitrary."

[9] The only decision of this Court relating to methods of valuation of inventories under Code § 471.

[10] Regs. 45, Art. 1582 (as amended by T.D. 3296, March 3, 1922).

Here, on the other hand, we have an inventory method which is in accordance with generally accepted accounting principles, rejected out of hand by the Commissioner after almost 60 years of silence. There can be no presumption of correctness to such administrative caprice.

References by the courts below to the "prepaid income" cases of *American Automobile Association* v. *United States*, 367 U.S. 687 (1961), and *Schlude* v. *Commissioner*, 372 U.S. 128 (1963), as sanctioning departures by the Commissioner from generally accepted accounting principles are inappropriate here.

Code § 471 was not involved in those cases. What was involved there was Code § 446(b), the general provision regarding methods of accounting, in the context of the enactment by Congress of Code § 452, permitting the deferral of prepaid income, and its abrupt repeal. The statutory history regarding the treatment of prepaid income was thus one of concern and confusion, rather than one of a clear congressional mandate, as here. There was there no long history of acquiescence by the Commissioner in the taxpayers' treatment of prepaid income, but rather a long history of dispute.

These cases hold only that Congress' abrupt repeal of Code § 452 gave legislative sanction to the Commissioner's disregard of generally accepted accounting principles as to prepaid income. They provide no authorization for the Commissioner to do so here.

Whether one characterizes the Commissioner's exercise of discretion here as arbitrary or merely unreasoned, it is urged that this Court should hold that Code § 471 does not sanction so blithe a disregard of the principles fashioned by the accounting profession. Absent such a holding, the rules of tax accounting will become a house built on sand.

CONCLUSION

The judgment of the court below, which, contrary to Code § 471, confers an unlimited discretion upon the Commissioner to disregard generally accepted accounting principles of inventory valuation, is not only incorrect, but will result in an unconscionable retroactive financial burden for American business. The NAM urges this Court to reverse that judgment.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on May 19, 1978, I served three copies of this Brief for the National Association of Manufacturers of the United States of America, as *Amicus Curiae,* upon each of the parties to this proceeding by depositing the same, enclosed in a sealed envelope with first class postage thereon fully prepaid, in a United States mail box at Chicago, Illinois, addressed to the attorneys for the parties as follows:

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